TMCnet NEWS

[February 01, 2008]

FX Markets Converge -- Brokers are giving savvy retail FX traders access to algorithms, and the buy side is benefiting from the boost in liquidity.

(Wall Street & Technology Via Thomson Dialog NewsEdge) Algorithmic trading has transformed foreign exchange trading. Hedge funds searching for alpha were the first to develop proprietary algorithms and models to trade FX as a distinct asset class, while investment managers seeking liquidity and anonymity in the FX markets are adopting dealer algorithms, according to a recent TABB Group report. But there is another phenomenon shaping FX trading: A new influx of liquidity is originating from retail traders who have access to streaming prices and sophisticated trading tools, helping to boost volumes further.

As online brokers and large banks make foreign exchange trading more accessible to retail traders, algorithmic trading is spreading beyond institutions to tech-savvy individuals, according to Thomas Plaut, CEO of FX Solutions, an Internet-based foreign exchange broker based in Saddle River, N.J., that provides a global trading system that specializes in the top 20 high-volume currency pairs. "We're seeing retail traders now come in building their own models and who are involved in high-frequency trading," he says.

Institutional FX market participants should not underestimate the abilities of retail traders, stresses Plaut, whose firm specializes in delivering non-latent prices to retail traders. "There is this misnomer in the market that retail traders are not good traders - that there is not smart flow," he observes. But, "It's the exact opposite."

FX Solutions white labels its systems to institutions that include aggregators of retail clients, small hedge funds and commodity trading advisers (CTAs). According to Plaut, his customers are savvy traders who are experienced in trading other asset classes. They are global - FX Solutions has customers in 120 countries - they tend to focus on three or four currency pairs and they are active 24-hours a day.

"You have retail traders who have significant programming skills and are highly educated and motivated to do well while access to the market has increased dramatically," Plaut says. In addition, "Transaction costs have decreased, so the playing field has leveled considerably."

Increasingly, foreign exchange trading - the world's most liquid market, in which the daily turnover is $3.2 trillion, according to the latest Bank for International Settlements report - has become more accessible to retail traders online. In addition, investment banks are delivering their own liquidity into proprietary portals or into aggregators of liquidity, which makes it easier for retail traders to buy and sell currencies.

According to Todd Crosland, CEO of Interbank FX, a Salt Lake City-based retail FX broker, the retail spot market currently is growing by 50 percent a year and is projected to grow at that rate for the next six to eight years. He says his firm has enjoyed compound annual revenue growth for the last four years of more than 390 percent and now has more than 19,000 customer accounts in more than 135 countries, including traders in Moscow and Beijing.

Interbank FX offers an automated trading system that allows customers to run their own algorithms. The retail trader downloads a program called Expert Advisor from Interbank FX's platform that enables the trader to create his or her own automated strategies. "After you write your strategy, you can back test it," says Crosland, who notes that tick data is saved for the traders.

Some of Interbank FX's retail traders execute 300 to 400 trades a day via an algorithm, which looks at all currency pairs, says Crosland, who adds that Interbank FX awards cash prizes to the most profitable traders on its system each month based on percentage gain. Crosland estimates that 15 percent to 20 percent of the firm's retail clients and 50 percent of the CTAs use automated trading.

Ascent of the Retail FX Trader

One buy-side trader who trades foreign currencies says he's noticed the ascension of the retail trader. "There is a big effort to appeal to these retail traders," observes Josh Levy, managing director at Tactical Asset Management, a CTA in New York that uses proprietary algorithms to trade FX in search of alpha.

"There is a convergence going on in that the historical market makers in institutional FX are reaching down to the retail set, while the players catering to the retail market are reaching up to the institutions," Levy continues. Firms such as Citibank, Deutsche Bank, ABN Amro and Lehman Brothers that were institutional-only are targeting retail clients, and firms such as Gain Capital, FXCM, Saxo Bank and even GFT (Globex Forex Trading) are going after the institutional market by offering low commissions and aggressive margin rates, he says.

In fact, some major banks and dealers that exclusively catered to institutions now are partnering with or investing in retail brokers. For example, in November, Citibank announced a partnership with Saxo Bank, a Copenhagen-based online bank, to launch CitiFX Pro, an online FX trading platform that will cater to sophisticated individuals and smaller institutional traders. The platform is being customized for Citi and will hit the market by early 2008, according to Lars Christiansen, co-CEO and cofounder of Saxo Bank, who says the tool includes streaming prices and will offer options functionality, though it will not offer research distribution.

In addition, CMC markets, an online broker that offers FX, recently received a 10 percent investment from Goldman Sachs, valuing the firm at $3 billion. Meanwhile, FXCM received a 10 percent capital infusion from Lehman Brothers.

The Liquidity Flood Gates

Ultimately, "The advent and ascendancy of the retail market is probably a good thing for the buy side to the extent that it brings more trading volume and liquidity into the FX market," comments Tactical Asset Management's Levy. He estimates that the top retail firms probably do about $100 billion or more a month in trading volume, which - if multiplied by 15 or 20 firms worldwide - amounts to a contribution in excess of $1 trillion of trading volume every month.

Hedge funds and the buy side, however, still remain major sources of FX liquidity, as well. According to a recent TABB Group report, "FX Algorithms: Bringing Best Execution to the FX Markets," buy-side volume as a percentage of total electronic FX trading activity has surged since 2000, and buy-side order flow represented, for the first time, more than 50 percent of daily electronic FX order flow at year-end 2006. The report predicts that interdealer trading will drop further to around 40 percent of all e-FX trading activity by year-end 2007, down from nearly 75 percent in 2000.

"Fueled by algorithms and other advanced electronic execution tools, hedge funds and asset managers will take up the slack, increasing their percentage of daily electronic trading in FX to just shy of 70 percent by 2010," writes Laurie Burke, TABB Group senior analyst and the report's author. Burke also predicts that with the ongoing growth in electronic trading and the fragmentation of FX liquidity across multiple ECNs, "FX algorithms will become standard fare on desktops of buy-side and sell-side traders alike."

Regardless of whether the source of order flow is retail or institutional, FX trading volumes stand to increase substantially as systematic and algorithmic trading grows. "Since computer models can trade 24/6 in the FX market, there isn't a human being that can come close to competing with that," notes Tactical Asset Management's Levy. "For us, we use our algorithms for when to trade, how to trade and what to trade," he continues. "There isn't any trading that we do that isn't automated. There's no portfolio manager saying, 'Now lets go out and buy $100 million Euroyen.' All the trades are conceived, executed and processed automatically."

Algos' Fleeting Effectiveness

All of this automation, however, means that the FX markets are highly efficient. Unlike in the past, when the wholesale (interbank) FX market was dominated by the human trader who was responsible for making markets, now it's all done systematically, explains FX Solutions' Plaut. "The computer is running all the algorithms, which makes all of our pricing instantaneous to clients," he describes.

Because quantitative hedge funds and market makers such as FX Solutions continually seek to leverage market inefficiencies, Plaut says, the markets have become more efficient and the algorithms need to be revamped more frequently. "Markets are highly observed," he notes. "What used to work for a year, now works for 90 days." This in turn creates demand for more algorithms and more quants with new ideas.

Tactical Asset Management's Levy agrees that algorithms have to be tweaked more often. But it's difficult to know whether the underlying reason for that is the entry of the retail set, he says. "It depends on which currency, which time zone, what style of trading your algo trades by, what are the rules of trading and what period of data you look at - whether its 5 minute intervals or daily or monthly intervals," Levy suggests.

Regardless, "Like any good traders, FX algorithms need to improve over time," writes the TABB Groups' Burke. "Liquidity migrates, and spreads shift. Effective FX algorithms need to be continually enhanced to respond to changes in currency market behavior. ... Developers of FX algorithms will build genetic adaptations to subtle changes in market behavior, no doubt running hundreds of permutations with different parameters of the same model, swapping in the most profitable ones and swapping out the least [profitable]."

advancedtrading.com

Algorithms began to surface in the FX market as early as 2005:

advancedtrading.com/showArticle.jhtml?articleID=169500451

View AT's exclusive directory of foreign exchange trading systems:

advancedtrading.com/directories/foreignexchange

[Back To TMCnet.com's Homepage]